THE SECTION 2 "MESS": DO WE REALLY NEED IT OR CAN WE AT LEAST MAKE IT BETTER?

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Thank you for the invitation to speak on exclusionary conduct, which I will take to refer to Section 2 of the Sherman Act generally. The views that I express are mine alone. They are not intended to, and do not, reflect the views of (nor have I sought input or reaction from) my firm, any of my partners, or any of my firm's clients.

Section 2 is a mess. Or at least the law that has developed under the statute is. The Supreme Court's recent decision in *Trinko* was helpful so far as it went.[1] The decision, however, only addressed a marginal part of the mess, and for every Supreme Court decision like *Trinko*, there are ten decidedly unhelpful lower court decisions like the *en banc* Third Circuit's decision in *LePage's*.[2] The efforts to clean up the mess through the use of ostensible rules based on catchy slogans like "profit sacrifice" or "raising rivals' costs" are likely only to make matters worse. Given the limited category of theoretical threats to competition that can only be reached by Section 2, the question arises (or at least should be raised) as to how much if any benefit the economy realizes from tolerating this sad state of affairs.

On the one hand, if this Commission were writing on a truly clean slate, the best approach might well be to do away with Section 2 altogether and rely on Section 1 of the Sherman Act (as well as Sections 3 and 7 of the Clayton Act). As I will explain, the threat to consumer welfare posed by conduct that is not subject to Section 1 is small and the whole Section 2 apparatus entails significant unavoidable costs. As a result, it seems to me unlikely that the benefits of Section 2 outweigh its costs. On the other hand, my name is not Don Quixote, and I, like the Commission, have to live in the real world. A more limited and realistic goal would be to encourage the development of bright line rules that impose burdens on plaintiffs to establish (under Section 2 or Section 1 for that matter) that allegedly exclusionary conduct logically and in fact threatens immediate harm to competition (as opposed to just the "opportunities of rivals") that clearly outweighs the conduct's plausible procompetitive potential.

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1 *Verizon Communications Inc.* v. *Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398 (2004). I am also attaching a short article providing my view of the significance of Trinko. *See* Charles F. Rule, "Monopolisation after *Trinko,*" *The Antitrust Review of the Americas 2005.*

2 *LePage's Inc.* v. *Minnesota Mining and Manufacturing Co.*, 324 F.3d 141 (3d Cir. 2003), *cert. denied,* 124 S. Ct. 2932 (2004).

In order to support what may seem, at first blush (and perhaps on further reflection), to be an outlandish proposal, I first describe a framework for evaluating the effectiveness of antitrust rules generally. Next I contrast Section 1 and Section 2, and explain that, even though it can be quite difficult, developing efficient enforcement rules under Section 1 is significantly more straightforward and inherently less speculative than is the case when constructing rules under Section 2. Then, I will explain why the various formulations like the "profit-sacrifice" for Section 2 über-rules are likely to make matters even worse than the current status quo. Rather, the world would probably be no worse off, on balance, if there were no Section 2. Finally, I will conclude with a few thoughts on what more efficient rules relating to exclusionary conduct might look like, given that Section 2 is likely to remain with us.

The Framework for Evaluating Rules

Though antitrust lawyers hate to hear it, the antitrust laws are regulations. Like other forms of regulation, the antitrust laws involve government intervention in the market to stop, modify, or require certain conduct by private parties in order to achieve some social benefit. And like any other form of regulation, an antitrust rule merits adoption and perpetuation only so long as its expected benefits exceed its costs. Put differently, to justify an antitrust rule, it is not enough to identify a problem; there must be some degree of confidence that the rule not only will correct the problem but also will not impose more costs on the economy than the problem itself.

In the case of antitrust rules, there has been for at least twenty-five years a consensus that the benefits must be measured in terms of "consumer welfare." That is, the law is concerned with private conduct that reduces total surplus by diminishing allocative efficiency without yielding a countervailing improvement in productive (or technical) efficiency. Moreover, the benefits must be measured dynamically, not statically. For example, private conduct designed to prevent free-riding may result in somewhat higher prices today; however, the elimination of free-riding may improve technical efficiency or product quality over time and so increase consumer welfare on balance.

In the first instance, then, in order for an antitrust rule to be warranted, it must be designed to detect and deter a practice that threatens routinely and substantially to reduce consumer welfare. If the practice's threat to consumer welfare is rare or trivial, it is probably not worth the effort required to devise an antitrust rule to address it. Even if the threat is real and substantial, that is only the beginning of the analysis required to determine whether an antitrust rule could and should be developed to identify and remedy the threat. Any rule developed to detect and eliminate a threat to consumer welfare will itself inevitably impose costs; if the rule is to be adopted, its benefits should outweigh those costs.

There are basically three types of costs that a rule is likely to impose. First, there are error costs - that is, the costs entailed when a rule generates false positives (i.e., falsely "detects" conduct that actually is procompetitive) or generates false negatives (i.e., fails to detect conduct that is anticompetitive). As a first approximation, there might seem to be no reason to be more concerned about false positives than false negatives or vice versa. However, if the conduct being detected has little prospect for generating efficiencies, false negatives should be a greater concern. Conversely, if the conduct is of a type routinely utilized in circumstances where it could not conceivably harm competition (because, e.g., it is used by new entrants or in unconcentrated, highly competitive markets), then the conduct is at the very least capable of generating efficiencies, and there is reason to be more concerned about false positives.[3] In addition, depending on how durable one believes false positives are as compared to false negatives, one may be more concerned about false positives than false negatives. For example, if one believes that market forces tend to self-correct anticompetitive conduct (at least eventually) but that courts are slower and more reluctant (e.g. because of *stare decisis)* to correct rules that generate false positives, one may be more concerned about false positives than false negatives.

Second, antitrust rules inevitably come with administrative costs. The huge cost of a Section 2 investigation and litigation by the government or of litigation by private plaintiffs, is well known to most of us in this room. Beyond the astronomical fees paid to lawyers, economists, and document specialists, the parties (particularly defendants) typically must incur enormous costs in terms of employee and executive time and distraction. Divestiture and prospective injunctive relief further increases the cost. Moreover, to the extent one tries to reduce error costs by increasing a rule's accuracy, that reduction almost certainly comes at the price of higher administrative costs.

The third type of cost derives from the uncertainty surrounding how an antitrust rule will apply to a particular practice. The uncertainty itself is a cost. Moreover, unclear and thus uncertain antitrust rules could also lead companies to be more conservative and less innovative for fear that they will inadvertently cross some line that results in the imposition of significant penalties.

Employing cost-benefit analysis in crafting and evaluating antitrust rules is not new. In the 1980s, at least in the Antitrust Division we explicitly used the framework in reviewing and modifying enforcement policy. At about the same time, then Professor Frank Easterbrook published his influential article, *The Limits of Antitrust.*[4] While, at the time, the insistence that the benefits of an enforcement rule exceed its costs and the explicit cataloguing of costs may have seemed novel (it was certainly controversial), it was hardly the first time courts and antitrust officials considered enforcement costs in crafting antitrust rules.

Indeed, the various per se rules that developed from almost the dawn of antitrust enforcement are predicated on the minimization of enforcement costs. For example, the per se rule against price-fixing reflects a recognition that such naked agreements among competitors

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3 If a practice is regularly used by firms without market power in competitive industries, then it is reasonable to conclude that the practice is efficient. In those settings, the practice is not being used to exclude competition (because any such attempt would be futile). The fact that the practice is prevalent in such settings indicates that it is efficient – the competitive benefits outweigh the practice's costs. In other words, the fact that a practice is widely employed over a significant period of time in competitive industries is a testament to the practice's procompetitive potential.

4 Frank H. Easterbrook, *The Limits of Antitrust*, 63 Tex. L. Rev. 1 (1984).

rarely if ever have any economically redeeming benefits; as a result the rule focuses on minimizing false negatives with little regard for the remote prospect of false positives. Moreover, by obviating the need to prove anticompetitive effects and by precluding an efficiencies defense, the per se rule tends to hold down administrative costs. Finally, the stark clarity and simplicity of the rule provides certainty to the business community about what is and is not permissible.

With the exception of the recent articulation of the recoupment test for predatory pricing in *Brooke*,[5] the rules developed by the courts under Section 2 have not reflected the same sensitivity to costs and benefits. Rather, the approach has been more "I'll know it when I see it" – certainly that is the most costly approach one can take to implementing an economic regulation. Fortunately, however, the courts have begun to recognize that a cost-benefit analysis should also be applied to Section 2 rules. In particular in its *Trinko* decision, the Supreme Court noted that the courts should avoid rules that generate "false condemnation" (i.e., false positives) "because they chill the very conduct that the antirust laws are designed to protect."[6] Moreover, the Court indicated that the "cost of false positives counsels against an undue expansion of §2 liability."[7] In addition, the *Trinko* Court showed a sensitivity to the administrative cost of Section 2 rules, counseling courts to avoid rules that require courts to act as "central planners . . . a role for which they are ill-suited."[8]

Section 1 versus Section 2

Despite this new-found interest in developing efficient Section 2 rules, the truth is that it is inherently easier to develop efficient rules under Section 1 of the Sherman Act than under Section 2. This reflects the fundamental difference between the two statutes – Section 1 addresses concerted conduct while Section 2 is focused on unilateral conduct.[9] As the Supreme Court has explained,

> "The reason Congress treated concerted behavior more strictly than unilateral behavior is readily appreciated. Concerted activity inherently is fraught with anticompetitive risk. It deprives the marketplace of the independent centers of

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5 *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993).

6 124 S. Ct. at 882, quoting *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 594 (1986).

7 *Id.*

8 *Id.* at 879.

9 Section 2, of course, also condemns "conspirac[ies] to monopolize" and concerted conduct in which a firm with monopoly power (or a dangerous probability of obtaining monopoly power) participates. However, if such conspiracies do not unreasonably restrain trade (i.e., on balance threaten consumer welfare) even though a monopolist or near-monopolist is involved, then those conspiracies should not be deemed to amount to monopolization. Conversely, if a conspiracy does unreasonably restrain trade, then Section 1 should condemn it and Section 2 is superfluous.

decision making that competition assumes and demands. In any conspiracy, two or more entities that previously pursued their own interests separately are combining to act as one for their common benefit. This not only reduces the diverse directions in which economic power is aimed but suddenly increases the economic power moving in one particular direction. Of course, such mergings of resources may well lead to efficiencies that benefit consumers, but their anticompetitive potential is sufficient to warrant scrutiny even in the absence of incipient monopoly."[10]

On the other hand, encouraging individual competitors to pursue their unilateral economic interests is the cornerstone of free-market competition and "it is sometimes difficult to distinguish robust competition from conduct with long-run anticompetitive effects."[11]

The difference goes even deeper than the fact that we are innately suspicious of agreements among competitors while we virtually idolize unilateral conduct in general. Section 1 and Section 2 treat the direct exercise of market power quite differently. Section 1 condemns agreements that serve to create or jointly to exercise market power, at least unless such an agreement is ancillary to generation of productive efficiency. So, for example, if competitors agree collectively to raise their prices, Section 1 condemns that agreement per se. Section 2, on the other hand, does not condemn the direct exercise of monopoly (that is, the exploitation of a monopoly to price above, and to restrict output below, competitive levels). To the contrary, as the Supreme Court recently explained in *Trinko*, the prospect of "possess[ing] . . . monopoly power, and the concomitant charging of monopoly prices . . . is an important element of the free-market system. The opportunity to charge monopoly prices . . . is what attracts 'business acumen' in the first place."[12]

This fundamental difference makes it much more challenging to craft efficient rules. At least conceptually, measuring the market power effects of an agreement (for example, a merger or joint venture) and comparing it to the agreement's potential efficiencies is relatively straightforward. As any antitrust practitioner who advises clients on joint ventures, mergers, and the like can tell you, however, that exercise can be quite difficult (and quite expensive) in practice. (As explained above, avoiding those costs is the reason the courts have adopted a per se rule of illegality for naked agreements not to compete.) In the case of Section 2 rules -- particularly those that involve unilateral conduct (e.g., refusals to deal, predatory pricing, and discount bundling), there are both serious conceptual and practical difficulties, and the practical difficulties are much more vexing than in the case of Section 1.

First, unlike concerted conduct that directly harms consumer welfare, predatory or exclusionary conduct (the focus of Section 2 rules) conceptually harms consumer welfare only

10 *Copperweld Corp.* v. *Independence Tube Corp.*, 467 U.S. 752, 768-69 (1984).

11 *Id.* at 767-68.

12 *Trinko*, 124 S. Ct. at 879.

indirectly; indeed, in some cases, like predatory pricing and discount bundling, the direct or immediate effect of the conduct may be to *increase*, at least temporarily, consumer surplus. As a consequence, application of Section 2 is inherently more complicated than Section 1. Rather than an attempt to identify and gauge the direct impact on consumer welfare of an agreement, Section 2 requires an *inference* of harm to consumer welfare based on harm to competitors. Drawing such an inference is fraught with error. There is no necessary correlation between the magnitude of the harm to competitors and harm to consumer welfare. One or more competitors may be driven from the market altogether; yet, if others remain or if entry (or re-entry) is quick and easy, there may be no threat to consumer welfare. Conversely, at least in theory, under certain circumstances (for example, in network industries), merely inconveniencing competitors (that is, putting them at even a slight cost disadvantage) may do great harm to consumer welfare. Predicting and tracing the causal link between harm to rivals and harm to consumer welfare is further complicated by the fact that procompetitive, efficiency-enhancing conduct generally will have the same impact on competitors as and thus be virtually indistinguishable from, anticompetitive exclusionary conduct. Put another way, it is often (if not always) difficult to tell whether conduct gives its author a competitive advantage because it improves efficiency or whether it provides an advantage by disadvantaging rivals.

Second, to the extent Section 2 is focused on unilateral conduct (because Section 1 makes Section 2 superfluous for concerted conduct), the target is inherently more elusive and ambiguous than an agreement. This is true for several reasons. Unlike the conceptually "clean" target presented by a concerted restraint, unilateral conduct that potentially could amount to anticompetitive exclusion is typically part of an overall competitive strategy, parts (perhaps the most or only effective parts) of which are undeniably procompetitive. The alleged exclusion may be intricately related to, and critical to the success of, the rest of the competitive strategy. And, while a judge or antitrust enforcement official might conclude that the allegedly exclusionary conduct is not necessary to the overall strategy, judges and antitrust enforcers have an awful track record when it comes to making such judgments. Moreover, unlike a case involving a concerted restraint that poses a direct threat to consumer welfare (where communications between the co-conspirators may yield enlightening evidence of intent), evidence concerning the subjective "intent" of a putative monopolist engaging in allegedly exclusionary conduct is worse than useless; such evidence is almost always misleading. Most successful business people are highly competitive, are driven to "win," and judge the success of their strategies on the basis of the strategies' success in attracting customers away from rivals. They may only know that the strategies work, not how they work. In addition, their language reflects the argot of business schools, with little regard for the priggish hypersensitivity of antitrust lawyers (at least until their company goes through a Section 2 investigation). In short, there is simply no empirical basis for believing that the "natural" language used by a firm employing the most efficient competitive strategies would be any different from the "natural" language used by a firm employing the most anticompetitive strategies.

Finally, the fact that Section 2 targets conduct that is unilateral and adversely affects consumer welfare only indirectly also makes crafting efficient and effective remedies inherently more difficult than in the case of Section 1. Unlike a concerted restraint that is defined by the parties' agreement and thus enjoined with relative ease, it is generally quite difficult to craft an injunction against unilateral conduct that is neither too narrow nor too broad. Moreover, even assuming the offensive conduct can be defined with precision, enforcing an injunction against unilateral behavior typically requires ongoing, potentially very costly regulation of a company. For that reason, structural remedies seem – at least on paper – very attractive; however, the economic cost of tearing asunder a monopoly that grew internally (as opposed to through merger) is usually huge and fraught with problems (including an *in terrorem* impact on the rest of the economy), with little guarantee of countervailing benefits.[13] Damages might seem to be a preferable alternative; however, given the absence of a correlation between the harm to rivals and the harm to consumer welfare, allowing rivals to sue for treble damages based on their injury is uniquely likely to yield inefficient levels of deterrence.[14]

"Sacrificing Profits," "Raising Costs," and Other Unhelpful Homilies

In light of the inherent, perhaps insoluble difficulties associated with developing rules to detect and remedy unilateral conduct that on balance represents a true threat to consumer welfare, it is not surprising that the courts historically have applied Section 2 on the basis of "I know it when I see it." True, the courts have indicated that Section 2 condemns "the willful acquisition or maintenance of [monopoly] power as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident."[15] If "willful" translates "by truly exclusionary or predatory means," the sentiment is correct; however, the pithy quote provides little guidance for identifying, much less remedying, truly anticompetitive unilateral behavior. Instead, courts have been pretty much been left to puzzle through complex and complicated facts to try to discern monopoly behavior on an *ad hoc* basis that often turns more on emotion than on logic. For example in a case like *Lorain Journal,* the conduct appeared to be pretty egregious and so it was condemned with relatively little thought given to whether it had any significant impact on competition.[16] The results have pretty much been random. Nevertheless, at least until recently, because the "monopoly power" screen has served to limit the number of cases, the adverse impact on the economy has probably not been significant.

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13 There is a story (albeit an undocumented one) that, when asked about the analysis of the costs and benefits of breaking up the old Bell Telephone system, the late Bill Baxter, who was the Assistant Attorney General in charge of the Antitrust Division of the U.S. Department of Justice at the time, replied that no such analysis was ever undertaken but that the Division took on faith that the benefits of the break-up outweighed its costs.

14 Because of the inherent problems with providing a rival injured by exclusionary conduct with treble damages, during the Reagan Administration the Department of Justice recommended amending Section 4 of the Clayton Act in order to limit treble damages to claims for overcharges to customers (or underpayments to suppliers).

15 *United States* v. *Grinnell Corp.*, 384 U.S. 563, 570-71 (1966).

16 *Lorain Journal Co. v. United States*, 342 U.S. 143 (1951). There is no indication in the opinion that any radio station was driven from the market or stopped competing for advertisements. It is at least as likely that the newspaper's refusal to deal with businesses that advertised in other media forced the other media to enhance the deals (e.g., lower the price) that they offered to advertisers. The conduct in other words looked irrational – it appeared to have been motivated solely to deprive competitors of business; however, there is no reason to believe it actually presented a serious threat to consumer welfare.

Into this void, a number of antitrust experts, including the Antitrust Division, have leaped, proposing over-arching approaches to analyzing unilateral conduct.[17] There are several different formulations; none are particularly promising and each has its problems. Two of the formulations that have received the most attention are referred to as "raising rivals' costs" and "profit sacrifice." Conceptually, both are reasonable, even promising. In practice, however, there is no reason to believe that either is particularly effective. Indeed, upon close scrutiny, those general formulations may impose even greater costs than the current ad hoc approach that they would replace. Let me mention a few of the most significant problems with each.

"Raising rivals' costs" has been around for a couple of decades, and it is the concept most closely associated with the so-called post-Chicago School movement in antitrust. According to the concept, a dominant firm may use certain practices to raise the marginal costs of rivals. By in effect shifting the industry supply curve up, the firm may be able to increase equilibrium prices (and reduce equilibrium output). In certain circumstances, by raising rivals' costs, a dominant firm may be able to exclude competitors from the market – for example, in a network industry, raising rivals' costs may enable a competitor to "tip" the market to itself. The "neat" thing about the concept (at least from the perspective of those looking for an excuse to attack dominant firm behavior) is that, according to the theory, consumer welfare can be harmed even if firms are not excluded from the market; it is sufficient that the practice raises the marginal firm's (or firms') costs relative to the costs incurred by the dominant firm. The classic example of such behavior is a dominant firm's use of exclusive arrangements to lock up the most efficient source of a critical input (a distribution channel) used to produce the good or service on which the dominant firm and its rivals compete. By excluding rivals from the most efficient sources, rivals are required to turn to less efficient (i.e., more costly) sources, their costs increase, and price in the market goes up.

There are numerous variations on this theme. While they typically make some sense, in practice it is very difficult to distinguish between situations in which a dominant firm raises its rivals' costs and situations in which a dominant firm lowers its costs *relative to* the costs of its rivals (and situations that are a mix of the two). Take for example the proverbial monopolist who locks up the efficient source of an input. No one would argue, I presume, that the law should prohibit the dominant firm from obtaining its requirements for the input from the most efficient source even if that means that other firms are forced to turn to less efficient sources. Just as with low prices, society benefits when all firms including monopolists strive to be as efficient as possible.[18] Since no one would argue with that presumption, the objection must be that the dominant firm has used exclusives to lock up more than it needs in order to deny rivals

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17 Professor Hovenkamp has recently published a helpful survey of the different proposals. *See* Herbert Hovenkamp, *Exclusion and the Sherman Act*, 72 U. Chi. L. Rev. 147 (2005).

18 One problem with the theory is that it assumes that the owners of the most efficient inputs are incapable of receiving a price for the input that reflects its value to the downstream industry. Unless rivals are completely asleep at the switch, they presumably will bid against the dominant firm for the efficient sources of inputs, likely driving up the price that the dominant firm must pay.

access to the source. However, even if the firm has secured more than it needs (and left rivals with access to less efficient sources), it is not necessarily the case that the conduct should be penalized. What if the dominant firm made a mistake in calculating its needs? What if the dominant firm were the first to discover the source and its inherent efficiency and locked up the newly discovered source in order to capture as much of the social value of the discovery as possible? In the latter case, penalizing the conduct will decrease the incentive to invest in making such discoveries and thus will reduce consumer welfare. Even in the case of a mistake, the cost of condemning the practice almost certainly exceeds its benefits.

Allow me to give another, real world example of the problems with applying the theory. Recall that in its case against Microsoft, one of the government's claims was that by "bundling" Internet Explorer with Windows and requiring OEMs to ship the bundle on PCs, Microsoft was raising the costs of its rivals, principally Netscape. Unlike Microsoft, Netscape had to convince OEMs to incur additional installation and support costs. Though consumers placed significant value in having a web browser pre-installed on their PCs, the incremental value that consumers attached to having a second browser (i.e., Netscape Navigator) on their machine was less clear and arguably not worth the extra installation and support costs. However, nothing that Microsoft did increased the cost of installing and supporting Netscape Navigator; regardless of whether Internet Explorer was on a machine, the OEM would have had to incur the same installation and support costs in order to distribute Navigator.[19] Rather, the real problem that Microsoft's conduct posed for Netscape was that the cost of installing and supporting Internet Explorer was inherently lower than Netscape's cost because Internet Explorer was automatically installed and supported when Windows was installed and supported. In other words, Internet Explorer had an inherent distribution-cost advantage that no third party could duplicate. The objection was not really that Microsoft had raised its rival's costs but that it possessed an unfair cost advantage (albeit one that directly benefited consumers). Similarly, the proposed remedy (fortunately rejected by the Department of Justice and the courts) to force Microsoft to "remove" Internet Explorer code from Windows was not so much about lowering the costs of rival browser vendors but rather was about eliminating Microsoft's inherent cost advantage and raising the software company's costs (or as Bill Baxter used to say, it was all about putting sand in Microsoft's saddlebags).

The more recent "profit sacrifice" approach is not much better than raising rivals' costs and is arguably worse. As with raising rival rivals' costs, the profit sacrifice test rests on sound conceptual grounds. The test is designed to condemn dominant firm conduct when (presumably only when) such conduct entails some sacrifice of short-term profits in order to impair the ability of rivals to compete and as a result to earn monopoly profits in the longer term. This test is just a generalization of the logic behind the current recoupment test used in predatory pricing cases.

19 There was an argument that by consuming hard-drive space, Internet Explorer did raise the cost of installing an additional browser. However, as the Court of Appeals ultimately concluded, the code that constituted Internet Explorer was an integral part of the operating system and the .exe file that exposed that code as a virtual web browser consumed a trivial amount of hard-disk space. Moreover, by the late nineties, even a full-blown web browser like Navigator consumed a very small fraction of a typical hard drive on a new PC.

However, while that recoupment test arguably works reasonably well (which is to say relatively few predatory pricing claims are able to survive its rigors), the generalized rule is dangerously error prone.

First, the profit sacrifice test pays scant attention to conduct's actual impact on competition and consumer welfare. Rather, at least the way the Department has articulated the rule, so long as conduct impairs rivals' competitive opportunities, a dominant firm must provide a business justification for the conduct (other than just disadvantaging rivals). Judging from the Department's briefs in the *Dentsply* case, the burden is on the dominant firm if the conduct disadvantages rivals in any way.[20] By making a showing of harm to competitors sufficient to switch the burden to a dominant firm defendant, the rule avoids the difficult task of identifying and quantifying the link between harm to competitors and the harm to competition. Thus, trivial (or even non-existent) threats to consumer welfare become legitimate targets of Section 2 condemnation in the absence of a convincing justification. Put another way, the profit sacrifice test creates a virtual per se rule of monopolization, albeit one in which the defendant has the ability (though, as explained below, a largely illusory one) to present an efficiencies defense.

Second, the test almost inevitably ends up shifting the burden to the defendant to prove that its conduct has some business justification other than simply reducing competition and enabling the defendant to charge monopoly prices in the future. However, this inevitability plays right into one of the historic weaknesses of Section 2. Judges and antitrust enforcers rarely have a clue as to how business works and would not recognize a legitimate justification if it punched them in the nose. For example, judges and antitrust enforcers routinely pooh-pooh claims that exclusive dealing is necessary to prevent free-riding on a dominant firm's investment in its distribution network. Yet the practice is prevalent throughout the economy, used by firms big and small in industries that range the gamut of imaginable concentration.[21] Moreover, even when judges recognize the efficiency potential of a practice, they are often prepared to believe that some less anticompetitive alternative (typically an unproven, impractical one) would work just as well.

Third and perhaps worst of all, the profit sacrifice rule inherently devolves into a subjective intent test. It is easy to dismiss a defendant's justification developed in litigation as self-serving and its economic expert's opinion as *post hoc* rationalization. Thus, the courts and antitrust enforcers search for contemporaneous evidence of the defendant's motivation for adopting the practice. All too often, all that the courts and enforcers find is a slew of emails filled with bellicose chest-thumping ("we're going to kill those SOBs" or "spare no expense, we've got to nip them in the bud before they take share and cut into our profits"), and no

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20 *United States v. Dentsply, Int'l., Inc.*, 399 F.3d 181 (3rd Cir. 2003)

21 If one sees a practice routinely used by firms that have no market power in competitive industries, that practice must at least have the potential for being efficient. *See* David S. Evans & A. Jorge Padilla, *Designing Antitrust Rules of Assessing Unilateral Practices: A Neo-Chicago Approach*, 72 U. Chi. L. Rev. 73 (2005).

contemporaneous quantification of the costs and benefits of the strategy. That is death in a profit sacrifice case.

Again, an example from the Microsoft case helps to illuminate the problems with the profit sacrifice test. In the original trial, the government cited the fact that Microsoft spent hundreds of millions of dollars developing and improving the code that constituted Internet Explorer only to turn around and include the code at no charge in Windows. According to the government, Microsoft sacrificed those hundreds of millions solely in an effort to exclude Netscape. To support their position, the government introduced plenty of belligerent emails and noted the absence in Microsoft's files of any cost-benefit analysis of the investment in Internet Explorer. According to the government's spin, the company was willing to keep pouring whatever it took in an effort to preserve the sales of Windows, Microsoft's monopoly product. A classic case of profit sacrifice the government argued, and Judge Jackson agreed (though ultimately the Court of Appeals rejected the argument).[22]

Where the Department saw profit sacrifice, I see an investment in innovation. Today, it is impossible to imagine personal computing divorced from browsing the web. An operating system that is incapable of accessing information in the "cloud" as easily as it accesses information on the local hard drive would be pretty worthless. By the mid-1990s, Microsoft realized that personal computing was becoming inextricably bound to the Internet, even though the success of Netscape was certainly one of the factors that awakened Microsoft to that reality. Given the swiftness with which the technological tide was sweeping the software world toward the Internet, Microsoft did not have the luxury of sitting back and trying to quantify the return on their investment. From Microsoft's vantage point, the question was not how much the investment would return but whether Windows could remain a viable, relevant operating system. Either Microsoft could ride the technological wave and try to enhance the Internet capability of Windows or it could ignore the importance of the Internet and sink into the deep blue oblivion of obsolescence. This is the way competition works – particularly in the face of rapid technological change like the development of the Internet. Businesspeople are often too caught up in riding the wave (or to mix metaphors, the "tiger") and trying to finish first to write the sort of pristine, analytical documents that we antitrust lawyers – or at least those advocating the profit sacrifice test – demand.

Section 2 – More Trouble Than It's Worth

None of the generalized Section 2 tests are likely to be very "efficient" in terms of identifying exclusionary conduct that truly threatens consumer welfare; moreover, none even purports to come to grips with the daunting remedial challenges posed by efforts to proscribe unilateral exclusionary conduct. Having said that, the authors of those tests do deserve some credit for their effort. It is not that the authors are incompetent or that there is some obviously superior general rule that they are too blind to see. Rather, given, as explained above, the inherent complexities of trying to identify and remedy unilateral exclusionary conduct that is

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22 *United States v. Microsoft Corp.*, 97 F.Supp.2d. 59 (D.D.C. 2000).

truly a threat to consumer welfare, it is very likely a futile task to try to devise an efficient general rule. Put differently (and antithetically from the perspective of the antitrust bar), the consumer-welfare cost of conduct that is not reached by Section 1 (or Sections 3 and 7 of the Clayton Act) but requires a special unilateral effects statute like Section 2 is arguably not significant, and so the best, most efficient rule might very well be no rule at all. The best reform of Section 2, then, might be to repeal the statute altogether.

Up to this point, some of the Commissioners perhaps could agree (at least grudgingly) with my description of the inherent complexities of attempting to identify and remedy unilateral exclusionary conduct. Perhaps a few of you would even agree with my critique of the raising rivals' costs and profit sacrifice tests. However, you all are probably thinking, "but now he wants to 'throw the baby out with the bath water.'" Section 2 is, after all, the second pillar of the "Magna Carta of free enterprise," the Sherman Act.[23] Beyond our romantic (and in the case of some us, personal financial) attachment to Section 2, the case in support of its importance to our economy is dubious. First, the sort of conduct that is uniquely subject to Section 2 proscription is limited; there are other antitrust and related statutes that more effectively deal with much of the conduct that has been the target of Section 2 over the last century. Second, as explained above, conduct that is uniquely subject to Section 2 is difficult to identify and remedy. Third, unilateral exclusionary conduct of the sort that Section 2 uniquely addresses probably poses little threat to consumer welfare anyway.

With respect to most conduct that presents a clear threat to consumer welfare, Section 2 is either inapplicable or redundant. Even if there were no Section 2, Section 1 (as well as Section 7 of the Clayton Act) would remain to proscribe direct acquisition of monopoly power through agreements like mergers, acquisitions, and joint ventures. Similarly, potentially exclusionary agreements like tie-ins, bundling, and exclusive dealing are also subject to Section 1 (and Section 3 of the Clayton Act) proscription.[24] Even invitations to collude – such as Robert Crandall's famous proposition to Howard Putnam in the early 1980s – which, in special circumstances, can be challenged as attempted monopolization are better (and today routinely) addressed as violations of the various federal fraud statutes.[25]

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23 *United States v. Topco Associates, Inc.*, 405 U.S. 596, 610 (1972).

24 This is not to say that it is vastly simpler to deal with such conduct under Section 1 of the Sherman Act. Although it is somewhat easier to segregate the restraint and to remedy it, there are still the complexities that arise from focusing on restraints that only indirectly harm consumer welfare and that clearly have procompetitive potential. The point is that, even in the absence of Section 2, other statutes would remain to address such restraints.

25 Spurned solicitations to collude do not violate Section 1 of the Sherman Act. However, a naked offer to collude (as opposed to an offer to enter into a productive integration like a merger) by one firm to another, in circumstances where collectively the two have monopoly power, may create a dangerous probability of achieving a monopoly. *See United States v. American Airlines, Inc*, 743 F.2d 1114 (5th Cir. 1984). Since the *Crandall* case, the Division has tended to pursue such invitations to collude as schemes to defraud, which, depending on the circumstances, transgress one of the several federal fraud statutes. *United States v. Ames Sintering Co.*, 927 F.2d 232 (6th Cir. 1990). Bringing such cases as criminal frauds is easier than trying to use Section 2 to pursue and deter such conduct.

There are only a few species of conduct that is subject to proscription by Section 2, but not by Section 1 – basically, force or fraud conduct, pricing and discounting behavior, and refusals to deal (including with respect to essential facilities). Perhaps the clearest case can be made for retaining Section 2 to deal with force or fraud.[26] There is relatively little risk of false positives from a Section 2 rule that prohibits, for example, a monopolist or near-monopolist from blowing up its rivals' plants. On the other hand, regardless of whether such unlawful force or fraud threatens consumer welfare or is perpetrated by a large or small firm, society has an interest in keeping the peace and deterring such conduct. Not surprisingly, then, there are other laws and legal concepts (like business torts) that are designed to proscribe such conduct throughout the economy, and there is no particular reason to believe that the presence of Section 2 significantly adds to the deterrence of such conduct.

As for pricing or discounting behavior, the history of Section 2 in this area is very suspect.[27] As the Supreme Court has observed, "predatory pricing schemes are rarely tried, and even more rarely successful."[28] Moreover, as Judge Frank Easterbrook explained over twenty years ago, predatory pricing cases are self-deterring – the predator absorbs losses which he may never recoup.[29] Nevertheless, at least until the Supreme Court's articulation of the recoupment test, the few predatory pricing cases that were litigated were outrageously long, with costs that were surely out of proportion to the slight danger posed by predatory pricing. With the *en banc* decision of the Third Circuit in the *LePage's* case involving "bundled discounts," there is a real danger of a repeat of the same costly litigation with little or no benefit to consumers.[30] Given the immediate benefits to consumers of vigorous price cutting and discounting, the threat posed by a particular alleged instance of predatory pricing or exclusionary discounting would have to be

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26 A recent example of such a case is *Conwood Co. L.P. v. United States Tobacco Co.*, 290 F.3d 768 (6th Cir. 2002).

27 Arguably, at least some cases challenging a putative monopolist's predatory pricing or exclusionary discounting (e.g., bundled discounts or loyalty discounts) could be attacked as restraints of trade under Section 1 of the Sherman Act. (They might also be challenged as primary line price discrimination under the Robinson-Patman Act. *See, e.g., Brooke Group Ltd.*, 509 U.S. 209. However, given the choice, I would repeal the Robinson-Patman Act before Section 2.) At least conceptually, because these practices involve completed sales agreements and agreements to provide discounts, Section 1 should be available to proscribe them when they in fact unreasonably restrain trade.

28 *See Matsushita Elec. Indus. Co.*, 475 U.S. at 589.

29 Frank H. Easterbrook, *Predatory Strategies and Counterstrategies*, 48 U. Chi. L. Rev. 263 (1981).

30 *LePage's Inc.*, 324 F.3d 141 (3d Cir. 2003), *cert. denied*, 124 S. Ct. 2932 (2004). I will leave to others a full critique of that decision. Suffice it to say, while much has been written about the case, I have yet to see any serious defense of the decision or any serious claim that such a rule against exclusionary bundled discounts has consumer welfare benefits that exceed its considerable costs. The case strikes me as a classic example of confusing an injury to a competitor – and in the case of LePage's, which continued competing in the market, even that injury was not very serious – with injury to competition.

very significant to justify the sort of administrative costs that are entailed in trying to identify and remedy truly anticompetitive pricing or discounting. In other words, even if there were no Section 2 and no other means of proscribing predatory pricing or exclusionary bundling, the cost to consumers would almost certainly be less than the cost of continuing to tolerate the current wasteful litigation and the dampening effect on vigorous competition imposed by the current rules.

That leaves only unilateral refusals to deal. Although I'm unaware of any systematic survey, my sense is that, if anything, such cases are even more unusual than predatory pricing claims. The few cases that do exist – *Lorain Journal, Aspen Skiing,* the *Kodak* and *Xerox* cases – are quirky to say the least. For example, as I explained above (see footnote 16), even in *Lorain Journal*, which is rarely criticized, it is not clear that the conduct at issue threatened to restrict output and harm consumer welfare.

Similarly, in *Aspen Skiing,* it appears that the defendant's conduct was intended to enable the "dominant" mountain owner to extract concessions from the owner of the other mountain in the area (or more precisely to force a sale by that owner). It is not clear that harm to consumer welfare was at stake. Keep in mind, the plaintiff wanted to force the defendant back into a joint venture, which presumably would set price and output of the combined mountains at the same level that would be set by a single owner of the mountains (that is, the defendant if it were able to force a sale by the plaintiff). Competition between the defendant and the plaintiff was almost certainly more intense after the defendant ended the venture and refused further dealing with the plaintiff than it was while the two owners were cooperating.

In *Kodak* and *Xerox,* given the competition that the defendant in each case faced (including from each other), it is unclear that the unilateral refusals to deal were a threat to consumer welfare. Fortunately, in both cases, the courts came to the correct outcome. Again, however, there is no reason to believe that society realized any significant benefit from the cost and uncertainty generated by those cases.

Even more significantly, in the case of unilateral refusals to deal, the only way conceptually to remedy the problem (other than treble damages and structural relief, which as explained earlier has serious problems in the context of unilateral behavior) is explicitly to regulate the monopolist's use of its property – dictating those with whom the monopolist must deal, describing and monitoring the terms (including price) of such dealings, etc. Not only is such regulation costly, it is perverse – requiring the monopolist to cooperate (at least to some extent) rather than to compete with potential rivals. In addition, such remedial regulation almost certainly reduces the monopolist's return on the asset (or assets) that the monopolist is required to share. The potential threat of what amounts to expropriation of the monopolist's property, moreover, raises some uncertainty throughout the economy as to whether those who successfully and lawfully create a monopoly or near-monopoly will be allowed to charge a monopoly price or instead will be required to share that monopoly with actual or potential competitors in order to avoid the claim that they are illegally maintaining their monopoly. All these costs hardly seem justified to catch and tame the elusive antitrust unicorn – that is the apocryphal refusal to deal that truly threatens consumer welfare.

Stepping back and surveying the overall impact of Section 2, it is far from clear that, if many of the most prominent Section 2 cases had never been brought, consumers and the economy as a whole would be materially worse off. Perhaps some of the early monopolization cases, like *Standard Oil*, were necessary to excise consumer welfare threats that were created prior to 1890, when Section 1 of the Sherman Act did not exist. One hundred fifteen years later, any such justification for Section 2 enforcement has long since disappeared. Of the more recent applications of Section 2 (leaving aside the Microsoft case, to which I am personally too close to make an objective judgment), the only one that may have made a difference was the AT&T case. However, that case is the exception that proves the rule.

AT&T (the old Bell System) was the product of a series of acquisitions that occurred decades before the Department filed its case in the early 1970s. As a result of those acquisitions AT&T owned a large percentage of the so-called local loops -- local bottleneck monopolies that were sanctioned and protected from competition by state and federal regulators. In exchange for that protection, AT&T's local rates were regulated and calculated to generate a certain rate of return that kept the rates below monopoly levels. Moreover, with the complicity of regulators, AT&T was able to use its control over its local monopolies to inhibit the ability of competitors like MCI to provide competitive long-distance service (in order, ironically, to subsidize the rates charged for local telephone service). In short, the regulatory process had worked to give AT&T the incentive and ability to use its monopolies over local telephone service to maintain its monopoly over long distance service.

The government's Section 2 case had more to do with a failure of the regulatory process and its resulting "infection" of potentially competitive markets than it had to do with a market failure caused by purely private market forces. When the regulatory and legislative process failed to correct the problem quickly enough, Section 2 was used to fill the void. One can legitimately question whether such a use of Section 2 is consistent with our democratic processes and whether the economic benefits of the ultimate remedy – breaking up the Bell System – outweighed the remedy's very significant costs. No matter how one answers those questions, however, the answers tell us very little about the value of using Section 2 to address unilateral exclusionary conduct that is not attributable to regulatory failure.

The bottom line is that it seems to me Section 2 has a lot of problems and not much in terms of off-setting benefits. The statute is a sacred cow and I suppose icons have important symbolic value. Moreover, as I can personally attest, the statute has been very rewarding financially for many of us in the bar. Nevertheless, it is hard to say that it has given consumers their moneys' worth, so to speak. Or put another way, there is little reason to believe there is *any* baby to worry about if you decide to throw out the bath water that is Section 2.

A Realistic Second Best – A Few Thoughts About Improving Section 2 Rules

Of course, I have no illusions about the prospects for repealing Section 2. It will not happen. Nevertheless, recognizing that the statute's inherent problems can help to minimize the damage that the statute does. That is, Section 2 rules should be developed and implemented with a focus on avoiding false positives and minimizing the administrative and uncertainty costs. This may mean that some potential threat to consumer welfare that can be described conceptually by a clever economist will evade detection. However, worrying about those "edge" cases is what has made Section 2 such a mess. In that light, please allow me to suggest, in no particular order, the top ten ways to reduce the costs associated with Section 2

1) Reserve Section 2 for conduct that can only be reached by that statute – If conduct is the result of an agreement, then it is subject to Section 1 (or, depending upon the conduct, Sections 3 and 7 of the Clayton Act) even if a monopolist or near-monopolist is a party to the agreement. If the conduct does not present a sufficient threat to consumer welfare to constitute an unreasonable restraint of trade, then it is not a sufficient threat to warrant condemnation under Section 2.[31] Rules developed under Section 1 reflect an exposure to conduct under a broader range of circumstances and are arguably more robust. There are problems even under Section 1 in attempting to proscribe potentially exclusionary conduct that only indirectly threatens consumer welfare (and some of the following suggestions are also relevant to the use of Section 1 to identify exclusionary restraints). Nevertheless, if for no other reason than lowering uncertainty costs, such conduct should be subject to a single standard – namely, the more general rule developed under Section 1 (or Sections 3 and 7 of the Clayton Act).

2) Reserve Section 2 for real, durable monopolies – Historically, one of the principal safeguards against a "run amok" Section 2 has been the requirement that the plaintiff prove that the defendant have monopoly power or that there is a dangerous probability the defendant will obtain such power. To some extent (perhaps due to the "smallest market" principle in the Merger Guidelines), it has become somewhat easier to prove narrow markets in which a defendant has a "monopoly." It is important to reserve Section 2 for defendants who have real (as opposed to trivial) and durable monopoly power.

3) Require the plaintiff to prove substantial, credible harm to consumer welfare (in the form of restricted output) – Simply proving that unilateral conduct impairs the competitive opportunities of rivals or even drives a competitor from the market should never be sufficient for the plaintiff to carry its initial burden of proof. Rather, the plaintiff should be required to tell a credible story as to the way in which the unilateral conduct will harm consumer welfare (that is, lead to a restriction in output) and present objective evidence to prove that the defendant's conduct will have such an effect. The current requirement that a plaintiff prove that a defendant can recoup its investment in predatory pricing is an example of this suggestion.

4) Require the plaintiff to prove that, "but for" the unilateral conduct, consumer welfare would not be harmed – It should not be enough for a plaintiff to show that it exited the market or that its costs were higher than the defendant's. Rather the plaintiff should prove the counterfactual – that is, in the absence of the challenged conduct, the plaintiff would have remained in the market or would have had costs as low as, or lower than, the defendant's. If the evidence indicates, for example, that the plaintiff was a victim of its own incompetence or was

31 Recently, particularly in antitrust complaints filed by the Department of Justice, a disturbing trend has developed in which the government fails to carry its burden that some potentially exclusionary restraint (typically, a tie-in or exclusive dealing) violates Section 1 but nevertheless prevails in condemning the restraint as a Section 2 violation. This happened in both the *Microsoft* and *Dentsply* cases.

simply slow or unable to adopt conduct that served to lower the defendant's costs (or to increase the demand for the defendant's product), then the plaintiff should lose.

5) Rely on objective evidence of anticompetitive effect and exclude ambiguous evidence of subjective intent – As explained earlier, evidence of bellicose intent toward a plaintiff is ambiguous at best and highly prejudicial at worst. It should not be allowed into evidence to prove that conduct harmed consumer welfare. Unilateral conduct should not be condemned unless the objective evidence establishes that the conduct will adversely affect consumer welfare.

6) If a plaintiff carries its burden that unilateral conduct will lead to a reduction in consumer welfare, the defendant should be allowed to rebut that proof with evidence of plausible efficiencies – A defendant should be allowed to show that its unilateral conduct enhanced efficiency either by itself or in conjunction with other conduct that complemented the challenged conduct. While a court should give significant weight to contemporaneous evidence that the defendant recognized the procompetitive potential of the conduct, the absence of such evidence should not be dispositive. In addition, courts and antitrust enforcers should approach a defendant's efficiency justification with humility and deference. Finally, in considering a proffered efficiency justification, a court should consider evidence that the conduct is in wide-spread use, particularly in situations where the threat to consumer welfare is incredible; if the conduct is prevalent in competitive industries, then it should carry a presumption of procompetitive potential.

7) Investments in the development and deployment of technological innovation should be viewed as an efficiency justification, never a threat to consumer welfare – Technological development is too critical to economic progress and advancements in consumer welfare ever to be the target of Section 2. To the contrary, to the extent that conduct reflects an effort to innovate or to enhance technology, it should be recognized as a significant efficiency justification.

8) Respect even a monopolist's choice as to whom it will or won't deal – Basically, simple refusals to deal, even by monopolists, should be per se legal. I cannot conceive of any other rule in this area that would be a net benefit to consumer welfare.

9) Do not condemn a monopolist's prices or discounts unless they are below some reasonable proxy for marginal cost – In other words the prevailing rule that prices are not predatory unless below marginal cost (as reflected by some observable proxy like average variable costs) should be extended to discounts, including bundled discounts.

10) To the extent possible, rely on remedies that narrowly prohibit the offending conduct – Narrowly focused proscriptive injunctions should be sufficient to remedy any truly harmful unilateral conduct. Broader remedies -- e.g., restructuring or affirmative injunctions -- should be avoided.

This top ten list will no doubt seem excessive to many. However, even if the suggestions were followed, one still could not confidently assert that Section 2 will generate net improvements in consumer welfare. The most that could be said is that the current excessive costs of Section 2 would be reduced somewhat.

Thank you for your attention. I look forward to your questions.